STATE OF CALIFORNIA
ELECTRICITY OVERSIGHT BOARD

Gray Davis, Governor

May 25, 2001

Mr. David P. Boergers, Secretary
Federal Energy Regulatory Commission
888 First Street, NE
Washington, D.C. 20426

Re: Williams Energy Marketing & Trading Company
Docket No. ER99-1722-004

Dear Mr. Boergers:

Enclosed for filing in the above-captioned docket are one original and 14 copies of the Joint Emergency Motion of the California Electricity Oversight Board and California Public Utilities Commission for Immediate Suspension of Market-Based Rate Authority and for the Institution of Refund Proceedings.

Thank you for your assistance.

Sincerely,

Grant A. Rosenblum
Staff Counsel
Electricity Oversight Board

Enclosures

cc: Official Service List of ER99-1722

tel 916.322-8601 770 L St., Suite 1250, Sacramento, CA 95814 fax 916.322-8591

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Williams Energy Marketing & Trading Company	Docket No. ER99-1722-004

JOINT EMERGENCY MOTION OF THE CALIFORNIA ELECTRICITY OVERSIGHT BOARD AND CALIFORNIA PUBLIC UTILITIES COMMISSION FOR IMMEDIATE SUSPENSION OF MARKET-BASED RATE AUTHORITY AND FOR THE INSTITUTION OF REFUND PROCEEDINGS

Pursuant to the Federal Energy Regulatory Commission's ("Commission") Rules of Practice and Procedure, 18 C.F.R. §§ 385.212, the California Electricity Oversight Board ("Board") and the California Public Utilities Commission ("CPUC") hereby jointly move the Commission to immediately: (1) suspend its grant of market-based rate authority to Williams Energy Marketing & Trading Company ("Williams") for the sale of energy and ancillary services from its generating resources in California[1] and to limit Williams to cost-based wholesale rates unless and until such time as the Commission imposes a mitigation plan for California's energy markets that can ensure just and reasonable rates and protect against the exercise of market power in California's energy markets; (2) to order refunds, together with interest, back to May 1, 2000, of the difference between cost-based rates determined for Williams' generation resources and the market revenues actually received; and (3) to institute a proceeding to determine whether, prior to May 1, 2000, Williams exercised market power resulting in unjust and

[1] Williams is a national energy services provider and a Commission-authorized power marketer that, among other things, buys and sells electricity in California wholesale energy markets. By "generation resources" the Board includes those facilities for which Williams has the exclusive right and responsibility to market and dispatch the output. These facilities include the following units owned by subsidiaries of the AES Corporation: AES Alamitos, L.L.C., AES Huntington Beach, L.L.C., and AES Redondo Beach,

unreasonable rates and, if answered in the affirmative, to order additional refunds, together with interest.

Based on the extremely dire situation in California's energy markets, and the fact that continued exercise of rampant market power continues to place California consumers and the State's economy (as well as the regional, and even national economy) in severe jeopardy, the Board and CPUC request that the Commission shorten Williams' response time to 7 days and act on this emergency motion within 14 days thereafter, or by no later than June 15, 2001.

I. CORRESPONDENCE AND COMMUNICATIONS

The principal office of the Board is located at 770 L Street, Suite 1250, Sacramento, California, 95814. All pleadings, orders, correspondence and communications regarding this motion should be directed to the following persons:

Erik Saltmarsh, Chief Counsel
California Electricity Oversight Board
770 L Street, Suite 1250
Sacramento, CA 95814
Tel: (916) 322-8601
Fax: (916) 322-8591
ens@eob.ca.gov

Sean H. Gallagher, Staff Counsel
Public Utilities Commission
of the State of California
505 Van Ness Ave., Room 5035
San Francisco, CA 94102
Tel: (415) 703-2059

II. INTRODUCTION

On April 2, 2001, the Board and CPUC moved to obtain party status to represent themselves, and the responsibilities the State of California has assigned to them, in the above-captioned proceeding. The Board's and CPUC's April 2, 2001 filings protested Williams' March 12, 2001 filing of an updated market power analysis for sales of energy and ancillary services into California's wholesale energy markets from its AES Facilities.

L.L.C., located, respectively, in Alamitos, Huntington Beach and Redondo Beach, California (collectively,

The protests were filed on the grounds that Williams has utterly failed to meet Commission requirements to provide an updated market power analysis concerning its power sales into California's wholesale energy markets. Moreover, the Board and CPUC pointed out that the Commission's methodology for evaluating market power is ineffective for California's wholesale energy markets and should be revised, but, that even under the current Commission methodology, Williams' updated market power evaluation is inadequate and inaccurate. Various other parties also filed protests to Williams' April 12, 2001 filing. To date, the Commission has failed to act on these protests and the associated requests for relief, including termination of Williams' market-based rate authority for the AES Facilities.

The threat to California's consumers and economy flowing from the Commission's continuing delay in this proceeding has been brought into greater relief by the Commission's April 26, 2001 *Order Establishing Prospective Mitigation and Monitoring Plan for the California Wholesale Electric Markets and Establishing an Investigation of Public Utility Rates in Wholesale Western Energy Markets*, 95 FERC ¶ 61,115 (2001) (April 26 Order). The April 26 Order necessarily acknowledges that California's electric wholesale markets fail to satisfy the Federal Power Act's ("FPA") mandate that prices be just and reasonable. The Commission concedes market power exists. Yet, the April 26 Order wholly fails to address, and may exacerbate, the pernicious effect on California's electric wholesale prices resulting from "megawatt laundering." Nor does the April 26 Order respond to compelling evidence before the Commission that market power is being exercised in all hours and in all markets in California. Only where market mechanisms and market-based rate authority produce just and reasonable prices

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the "AES Facilities").

can cost-based ratemaking be supplanted. Thus, absent a mitigation plan that adequately eradicates market power abuse, the Commission cannot lawfully authorize market-based rate authority for Williams or any other jurisdictional public utility.

The Board and CPUC believe that the urgent need to restore just and reasonable wholesale electric prices in California justifies seeking an expedited response from the Commission.[2] Williams has, and continues to, exercise significant market power to the detriment of California and its citizens. The potential harm from market power abuse increases daily as California enters into its summer peak season. In light of these factors as well as the May 29, 2001, implementation date for the inadequate mitigation measures adopted in the April 26 Order, further Commission delay will be deleterious to California's consumers and economy. Accordingly, the Board and CPUC request that the Commission act upon this request to terminate Williams' market-based rate authority on or before June 15, 2001, or alternatively, impose by that date a region-wide mitigation plan that addresses the exercise of market power in all hours for all short-term sales and adequately protects against "megawatt laundering."

III. MARKET PARTICIPANTS, INCLUDING WILLIAMS, ARE GUILTY OF EXERCISING IMPROPER MARKET POWER IN CALIFORNIA'S WHOLESALE ELECTRIC MARKET

The Commission has repeatedly acknowledged that "the electric market structure and market rules for wholesale sales of electric energy in California are seriously flawed and that these structures and rules, in conjunction with an imbalance of supply and demand in California, have caused, and continue to have the potential to cause, unjust

[2] The Board and CPUC recognize that effectuation of any refund relief cannot be rendered immediately, or fully rendered, within the timeframe requested. However, the Commission may immediately suspend Williams' market-based rate authority.

and unreasonable rates for short-term energy."[3] Substantial, credible evidence before the Commission has affirmatively linked the exercise of market power to the admittedly unjust and unreasonable wholesale electric rates plaguing California.[4] The details and methodology of the evidence on record demonstrating the existence of pervasive market power abuse is well known to the Commission and need not be repeated. However, it is important to emphasize that the evidence exposes the fallacy perpetuated by the Commission that market power affects California markets only during periods of reserve emergencies and does not taint the reasonableness of short-term bilateral transactions**.**

The record in this proceeding is not limited to evidence of generic, systemic market power abuse by unidentified market participants. Rather, overwhelming and uncontradicted evidence verifies that Williams has reaped undue profits through the exercise of market power at Californian's expense, and that such unlawful exercise of market power began at least as early as May 2000. Specifically, the ISO submitted as Attachment A to its protest in this proceeding, a detailed analysis of the specific bidding behavior of Williams from May through November 2000. The analysis submitted reaches the following conclusions:

- Williams, among others, displayed bidding patterns which were consistent with the exercise of market power. The study concluded that Williams bid in excess of the marginal cost of generation through either economic or physical withholding and bid in expectation of increasing the market clearing price ("MCP"). (Report at 1).

- Economic and physical withholding were the bidding strategies used by Williams to inflate prices, and these actions had a significant impact in

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[3] *Order Proposing Remedies for California Wholesale Markets,* 93 FERC ¶ 61,121 (2000), slip. op. at p. 5; see also, *Order Directing Remedies for California Wholesale Market,* 93 FERC ¶ 61,294 (2000).

[4] See, e.g., Further Analyses of the Exercise and Cost Impacts of Market Power in California's Wholesale Energy Market, attached as Exhibit B to Intervention and Protest of the California Independent System Operator Corporation, Docket No. ER99-1722-004 (April 9, 2001); Empirical Evidence of Strategic Bidding in California ISO Real-time Market, attached as Exhibit C to Intervention and Protest of the California Independent System Operator Corporation, Docket No. ER99-1722-004 (April 9, 2001); Impacts of Market Power in California's Wholesale Energy Market: More Detailed Analysis Based on Individual Seller Schedules and Transactions in the ISO and PX Markets (April 9, 2001).

raising MCPs. The CAISO Department of Market Analysis ("DMA") estimates that Williams economically withheld during 72 percent of the hours in May through November 2000, and engaged in physical withholding in 28 percent of the hours.

- DMA found only 17 hours among the entire 5,137 hours during the period in which Williams did not withhold capacity either economically or physically, thereby exercising market power in nearly every hour from May through November 2000. (Report at 2).

- As a result of its exercise of market power, Williams earned extraordinary amounts of excess profit (or monopoly rents) and imposed huge costs on electricity consumers in California. (Report at 3).

- Williams clearly exercised significant market power in the California electricity markets from May through November 2000. Furthermore, nothing has changed since November 2000 to reduce the amount of market power held by Williams in the California electric markets. Indeed, additional analysis of Williams' bidding behavior over the following four months indicates an even greater exercise of market power. DMA estimates that during the period from December though March 2001, Williams' sales to the CAISO real-time market were approximately $116 million in excess of its costs. This analysis covers the period of December 8-31, 2000, when the CAISO implemented a soft price cap of $250/MWh and the most recent period of January through March 26, 2001, when, pursuant to the Commission's December 15, 2000 Order, the ISO changed its soft cap to $150/MWh. (Report at 7).

IV. MARKET-BASED RATES MAY BE AUTHORIZED ONLY WHERE THE RESULTING CHARGES FALL WITHIN THE ZONE OF REASONABLENESS

Rates for wholesale power must be "just and reasonable." 16 U.S.C. §§ 824d, 824e. Indeed, the primary responsibility of the Commission is to "guard the consumer against excessive rates." *City of Detroit v. Federal Power Comm'n*, 230 F.2d 810, 817 (D.C. Cir. 1956). "[T]he Commission has the duty—not the option—to reform rates that by virtue of changed circumstances are no longer just and reasonable." *Louisiana Public Service Comm'n v. FERC*, 184 F.3d 892, 897 (D.C. Cir. 1999).

The FPA does not prescribe the manner of determining just and reasonable rates. Nevertheless, cost of service ratemaking constitutes the traditional means by which the Commission has determined whether rates are just and reasonable. This reflects the underlying purpose of the FPA which is to avert prices inflated by market power by emulating the theoretical outcome of a competitive market, i.e., the setting of prices that cover the producer's costs and provide an incentive to ensure the continuing provision of services. See, *Federal Power Comm'n v. Hope Natural Gas Co.,* 320 U.S. 591, 603 (1944). The reasonableness of rates, therefore, must be measured against costs:

> For, though we hold that [the cost-based ratemaking] method not to be the only one available under the statute, it is essential in such a case as this that it be used as a basis of comparison. It has been repeatedly used by the Commission, and repeatedly approved by the courts, as a means of arriving at lawful-- 'just and reasonable'-- rates under the Act. Unless it is continued to be used at least as a point of departure, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms 'just and reasonable' to some recognizable meaning.

City of Detroit v. Federal Power Comm'n, 230 F.2d at pp. 818-819; see also *Public Service Company of New Mexico,* 25 FERC ¶ 61, 469 at 62, 053 (1983) ["if our hypothesis that competitive market forces will restrain prices were wrong, we would be able to observe utilities with market power exercising that power by consistently charging prices above cost… [S]uch results … would be damaging, at least in the short-run, to the consumers we are bound to protect."]. This is especially true in the context of electric generators, in contrast to "transportation companies," such as oil pipelines, where the Commission has recognized the "necessary connection between revenue recoveries and the cost of service." *Farmers Union Cent. Exchange v. FERC,* 734 F.2d at 1493.

As such, when the Commission departs from cost-based ratemaking, it must demonstrate that market forces can be relied on to keep prices within a zone of reasonableness. *Farmers Union v. FERC*, 734 F.2d at 1502; see also, *Tejas Power Corp. v. FERC*, 908 F.2d 998, 1005 (D.C. Cir. 1990) [settlement was overturned in the absence of "substantial evidence upon the basis of which the Commission could conclude that market forces will keep Texas Eastern's prices in reasonable check."]. By definition, market forces are incapable of properly regulating prices where the seller possesses market power and no mechanism exists to mitigate the exercise of such power. See, *Conectiv Energy Supply, Inc.*, 91 FERC ¶ 61,076 at 61,270 (2000). It is precisely to ensure that market power is not perverting competitive forces, and obstructing the realization of just and reasonable prices that all sellers with market-based rate authority must reestablish eligibility for that authority no less often then every three years.

V. THE COMMISSION MUST SUSPEND WILLIAMS' MARKET BASED RATE AUTHORITY, OR, ALTERNATIVELY IMPOSE AN ADEQUATE MITIGATION PLAN.

A. Williams Fails To Sustain Its Burden That It Cannot, And Does Not, Exercise Market Power.

An applicant seeking market-based rate authority carries the burden of establishing the absence of an ability to exercise market power, or the adequate mitigation of such ability. *Entergy Services, Inc.*, 58 FERC ¶ 61,234. The wisdom of allocating responsibility to the applicant is clear – market-based rate authority is a privilege, not an entitlement. Given the record against Williams compiled in this proceeding, Williams' patently inadequate "Updated Market Power Analysis" demands summary rejection.

Williams Updated Market Power Analysis addresses its "generation market power" in the context of the AES Facilities for which it has exclusive right to market and dispatch the output. This is the only section of the Updated Market Power Analysis that concerns Williams' power marketing activities in California's energy markets. This "analysis" states in its *entirety* as follows: "[b]ecause the Commission has recently granted WEM&T market-based rate authority to make these sales, which remain subject to Commission review, there are no market power concerns with respect to WEM&T's sales from these facilities." Updated Market Power Analysis at pp. 4-5.

Williams has provided no analysis whatsoever of its market share with regard to California energy markets, and by this omission, has entirely failed to meet Commission requirements to demonstrate that it either lacks market power or has adequately mitigated market power. Williams has merely provided a cursory and conclusory statement devoid of any analytic support.

It goes without saying that after the "recently granted WEM&T" authorization -- upon which Williams' Updated Market Power Analysis depends *in toto* – there have been significant structural modifications in the California markets, including, without limitation, the use by the investor-owned utilities of their own generation and entitlements to serve native load, the demise of the PX, and the creation of a third zone for congestion management. At an absolute minimum, it was incumbent upon Williams to address those changes. But its responsibility did not stop there. Equally important, Williams relies on the purported fact that its sales "remain subject to Commission review," specifically referring to the Commission's March 9, 2001 Order in Docket Nos.

EL00-95-000 et al.[5] Again, this is now untrue for all practical purposes. As discussed further below, unlike the March 9, 2001 Order methodology, marketers such as Williams are free to cost justify their bids with regard to their cost, without any real examination of the source or cost of generation.

The utter paucity of Williams' submission is further highlighted when juxtaposed against the Commission's Show Cause Order, issued on March 14, 2001, in Docket No. IN01-3-000, directing Williams, AES and AES subsidiaries to show cause why they should not be found to have engaged in violations [of Section 205 of the Federal Power Act and agreements on file with the Commission] and directed to make refunds and have certain conditions placed on Williams' market-based sales authority for a limited period (March 14, 2001 Show Cause Order).[6] In the March 14, 2001 Show Cause Order, the Commission states: "Information contained in the non-public Appendix indicates that Williams and AES may have acted together to exercise locational market power with respect to Alamitos 4 and Huntington Beach 2." March 14, 2001 Show Cause Order, slip op. at p. 11.

Plainly, the Commission recognizes the potential for Williams and AES to exercise locational market power and to charge resultant unjust and unreasonable rates for power sales from the AES Facilities. These Commission findings contradict Williams' conclusory submission, requiring that the Commission discharge its statutory duty by rejecting Williams' Updated Market Power Analysis.

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[5] San Diego Gas & Electric Company v. Sellers of Energy and Ancillary Services, et al., 94 FERC ¶ 61,245 (March 9, 2001).

[6] 94 FERC ¶ 61,248 (2001). The March 14, 2001 Show Cause Order is the result of a preliminary, non-public investigation conducted by the Commission staff concerning Williams' and AES' failure to provide power from certain designated reliability-must-run (RMR) generation units located in Orange County, California during April and May 2000 (the Huntington Beach 2 and Alamitos 4 units).

B. The Commission's April 26 Order Fails To Adequately Mitigate Market Power So As To Permit Continuance Of Market-Based Rates.

"Without empirical proof" that the market will constrain rates to levels that are just and reasonable (*Farmers Union,* 734 F.2d at 1510), and without "substantial evidence upon the basis of which the Commission could conclude that market forces will keep … prices in reasonable check" (*Tejas Power Corp.*, 908 F.2d at 1005), the Commission may not, as a matter of law, permit the continuation of market-based rates. The April 26 Order extends price mitigation to Stage 1 and 2 emergency conditions, in addition to Stage 3 emergency conditions. However, in so doing, the Commission implicitly assumes that California's electricity wholesale market is workably competitive in non-stage conditions. This assumption is a fallacy and the empirical evidence is directly contradictory.

The Commission's delay in acting in this proceeding reflects its continuing disregard of uncontroverted evidence that extremely high prices often prevail during non-emergency conditions. Such evidence establishes that prices are unreasonably high even in low load conditions. For example, in March—one of the lowest demand months of the year—average real-time imbalance energy price for non-emergency hours was $440/MWh while the average price under Stage 3 emergency conditions was $377/MWh.[7] (The average price for Stage 1 emergency hours was $390 and for Stage 2 emergency hours, $359.) Note, as well, that the Commission's proxy price (as calculated pursuant to the March 9 Order) for March was $300, lower than any of the average prices during both non emergency and emergency condition, even though the proxy price

[7] Testimony of Patrick K. McCauliffe on Behalf of the California Electricity Oversight Board, Attachment A to Request for Rehearing of the California Electricity Oversight Board of the April 26, 2001 Order, Docket No. EL00-95-012, et al. (May 25, 2001), at p. 3.

is intended to establish the competitive price of the most expensive unit needed under the most extreme circumstances.

Clearly, the Commission's theoretical basis for limiting mitigation to emergency conditions - the assumption that in non-emergency conditions, adequate supply exists to keep prices competitive, i.e. low enough to be considered just and reasonable - is plainly wrong. Time after time in this proceeding, the Commission has been shown that this assumption does not square with the facts and is in complete contradiction to the evidentiary record. Prices in California have been unreasonable in most hours and under most conditions and conditions have only gotten worse. Professor Frank Wolak recently estimated that, based on prices in the first two months of 2001, total electricity costs in 2001 could reach $70 billion. This compares to estimated costs of $6 billion for 1998 and $7.43 billion for 1999. The Commission's choice is manifest – it must either extend genuinely effective mitigation to all short-term markets or suspend market-based rate authority.

Even as to that segment of the market, i.e., the CAISO real-time market, that the Commission admits is "broken," its fix is wholly inadequate and may exacerbate ongoing market power abuse. The April 26 Order fails to remedy megawatt laundering although the Commission acknowledges the existence of the problem and has indicated that it will consider it in the context of its investigation into public utility sales for resale in the western region. Megawatt laundering occurs when an export is sold and scheduled from within the CAISO-controlled grid to a point outside the grid and then resold as an import back into the CAISO-controlled grid at a much higher price. In the past, sellers were able

to avoid the CAISO's hard price caps by reselling through the CAISO "out of market" at prices above the price caps.

Under the April 26 Order, imports are still not subject to price mitigation. During hours when the price is mitigated in California, imports can elect to be paid either the proxy market-clearing price or be paid as bid. In addition, the April 26 Order allows marketers to be paid as bid subject to cost justification. However, the April 26 Order allows cost justification to be based on the price the marketer paid for power, which may bear no relation to the costs of the resources used to generate the power. This loophole allows market participants, such as Williams, to churn contracts at ever increasing prices that will be deemed by the Commission to be cost justified even though prices may be far in excess of what might be considered just and reasonable.

Markets can supplant cost-based regulation only where prices will not be elevated through the exercise of market power. The Commission has acknowledged that California's market structures are "seriously flawed." Yet, the Commission has failed to address the vast bulk of transactions corrupted by the flaws in California's electric wholesale markets, and as to those transactions it does attempt to address, the Commission has done so in a grossly inadequate fashion. Thus, unless the Commission immediately suspends market-based rate authority or implements a comprehensive and effective mitigation plan, the Commission necessarily abdicates its statutory responsibility to ensure that rates are just and reasonable.

VI. WILLIAMS SHOULD BE ORDERED TO DISGORGE MONOPOLY RENTS.

The primary relief requested by the Board and CPUC is for the Commission to staunch the hemorrhaging California ratepayers have suffered, and will continue to

suffer unless action is taken to properly mitigate market power abuse. Nevertheless, all rates tainted by the exercise of market power by Williams or other market participants, whether past or future, are illegal. The Commission must do more than prospectively thwart illegal rates. The Commission must also take affirmative action to make California ratepayers whole by fully reversing the injury inflicted by past market power abuse. Accordingly, the Commission must direct refunds for all transactions in which Williams exercised market-based rate authority above Commission established resource specific cost-based levels.

In its August 23, 2000 Order,[8] the Commission established an October 2, 2000, refund effective date. Limiting refunds to this date and forward would be an abuse of discretion under the record in this proceeding for two reasons. First, the CAISO has provided conclusive empirical data that the California electricity wholesale markets became "dysfunctional" at least as early as May 2000. The predicate for market-based rates – a workably competitive market – no longer existed. From that date, and perhaps earlier, Williams began reaping illegal monopoly rents that must be disgorged.[9]

Second, the filed rate doctrine does not present a legal barrier to establishing retroactive refunds in the context of market-based rate authority. Market-based rates are analogous to formula rates. Both formula and market-based rates permit fluctuation of charges without Commission review. Since the Commission is not changing the rate methodology, but merely adjusting revenue to align with the underlying rate model,

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[8] 92 FERC ¶ 61,172.

[9] In light of the evidence compiled against Williams and the Commission's own conclusions expressed in the Show Cause Order, the very real likelihood exists that Williams exercised market power prior to May 2000. This record requires that the Commission institute an investigation of Williams' transactions prior to May 2000, to determine if market power was improperly exercised and, if so, to direct the refund of excess revenues thereby obtained.

retroactivity is not implicated. Simply put, a rate that does not correspond with that which the seller would receive in a workably competitive market is inconsistent with its market-rate based authority. The Commission has consistently recognized that it possesses the authority under such circumstances to impose refund obligations. See, e.g., *Connecticut Yankee Atomic Power Co.*, 40 FERC ¶ 63,009 (1987); *Louisiana Public Service Comm'n v. Entergy Services, Inc.*, 67 FERC ¶ 61,338 (1994); *Alabama Power Co. v. FERC*, 993 F.2d 1557 (D.C. Cir. 1993).

Thus, the Commission possesses the factual basis and legal authority to order Williams to disgorge all excess revenue received since May 2000 that is the product of its exercise of market power. It must now exercise such authority.

VII. CONCLUSION

Based on the foregoing, the Board respectfully requests that the Commission:

(1) suspend the authority of Williams to sell either energy or ancillary services at market-based rates from units located in California for which it has the entitlement to market the output, and to limit Williams to cost-based wholesale rates, unless and until such time as the Commission imposes a mitigation plan for California's energy markets that can ensure just and reasonable rates and protect against the exercise of market power in California's energy markets; and

(2) order refunds, together with interest, back to May 1, 2000, of the difference between cost-based rates determined for Williams' generation resources and the market revenues actually received; and

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(3) to institute a proceeding to determine whether, prior to May 1, 2000, Williams exercised market power resulting in unjust and unreasonable rates and, if answered in the affirmative, to order additional refunds, together with interest.

Dated: May 25, 2001

Respectfully submitted,

Grant A. Rosenblum
Staff Counsel
Electricity Oversight Board
770 L Street, Suite 1250
Sacramento, CA 95814
(916) 322-8601

CERTIFICATE OF SERVICE

I hereby certify that I have caused the foregoing document to be served upon each person designated on the official service list compiled by the Secretary for this proceeding on or before May 29, 2001.

Dated at Sacramento, California, this 25th day of May, 2001.

Grant A. Rosenblum
Electricity Oversight Board
770 L Street, Suite 1250
Sacramento, CA 95814
(916) 322-8601